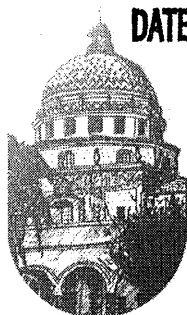


ADDENDUM MATERIAL

DATE 6-22-21

ITEM NO. ADD 10

Laura Conover
Pima County Attorney



(520) 724-5700
pcao.pima.gov
32 N. Stone Avenue, Suite 2100
Tucson, AZ 85701

Civil Division

Attorney Client Privilege/Confidential

This is a privileged attorney-client communication and should not be disclosed to persons other than Pima County officials and employees involved in the matter that is the subject of the communication. The privilege is held by Pima County and can be waived only by an official action of the Board of Supervisors.

To: C.H. Huckelberry, County Administrator
From: Michael LeBlanc, Deputy County Attorney
Date: May 26, 2021
Subject: Legal Issues Raised by the City of Tucson's Proposal to Adopt Differential Water Rates on June 8, 2021

You asked for a review of the legal options available to the County should the City of Tucson adopt an ordinance that would apply differential water rates to the same class of customers based solely on whether a customer is within the jurisdictional boundaries of the City. This memorandum focuses on the procedural and substantive legal issues presented by the City's proposal that may be raised in a potential challenge to the ordinance. If the Mayor and Council adopt an ordinance on June 8th, I will submit another memorandum addressing specific causes of action, potential remedies, and the risks of litigation for the County and the class of customers affected by the rate structure.

1. Background

The City's authority to provide water service to nonresidents and to set municipal water rates is regulated by the legislature. If a municipality establishes water service to nonresidents, the municipality must continue the service for as long as the municipality owns or controls the utility. A.R.S. § 9-516(C). In a 1989 opinion, the Arizona Supreme Court interpreted this requirement to mean that the charges for such services must be set at reasonable rates. *Jung v. City of Phoenix*, 160 Ariz. 38, 40 (1989). The Court explained:

“If such a construction is not adopted, a city could charge any rate it wished despite its effect on the nonresidents’ need for utility service. The legislature did not intend to place nonresidents of a city in such an impossible situation.”

The legislature has since codified the Court’s interpretation in A.R.S. § 9-511.01 which requires that any water rate increase proposed by a municipal utility be “just and reasonable.” The statute also establishes the procedures that municipalities must follow before increasing water rates. The municipality must provide notice of the increase to the public and prepare a report or data supporting the increase. If a municipality adopts the proposed rate, the rate is effective 30 days after the adoption unless a referendum petition is filed. A.R.S. § 9-511.01(C). Once effective, the “rates and charges demanded or received by municipalities for water” must also be just and reasonable. A.R.S. § 9-511.01(E). Every unjust or unreasonable rate or charge demanded or received by a municipality is prohibited and unlawful. A.R.S. § 9-511.01(E).

- 2. The City may not have complied with the notice requirement of A.R.S. § 9-511.01(A)(2) when the Mayor and Council did not notify the public of the proposed increase in rates that will be considered at the June 8th meeting.*

If a municipality seeks to increase any water rate, the municipality must adopt a notice of intention to increase the water rate and set a date for a public hearing on the proposed increase at least 60 days after adopting the notice of intention. A.R.S. § 9-511.01(A)(2). On April 6, 2021, the Mayor and Council adopted Resolution 23321 approving the Notice of Intention “to implement a differential rate structure for Tucson Water customers located in unincorporated Pima County.” The hearing on the “proposed increases” is set for June 8, 2021.

Neither the City’s Resolution nor the Notice identify what “proposed increases” the Mayor and Council will consider at the June 8th hearing. According to the Legal Action Report for the April 6, 2021 meeting, the Mayor and Council unanimously approved Resolution 23321 and directed staff “to file all necessary documents with the City Clerk and all of their actions to allow the Mayor and Council to consider differential rates up to but not exceeding 50%.” Tucson Water published the “Proposed Differential Rates for Unincorporated Pima County Customers” on May 7, 2021 which provides eight different rate structures for the Mayor and Council to consider.

Though no Arizona court has interpreted the notice requirement in A.R.S. § 9-511.01(A)(2), the plain language of the statute supports an argument that the City must first select a rate increase and then provide the public with notice of that increase. This intent is also supported by the plain language requiring the City to “prepare a written report or supply data supporting the *increased rate*” at least 30 days prior to the June 8th hearing. A.R.S. § 9-511.01(A)(1)(emphasis added). In contrast, the City has issued a notice that the June 8th hearing will consider proposed increases that were undetermined at the time the notice was adopted. Those proposed increases were not available to the public until almost a month after the Mayor and Council approved the Notice. And it remains unclear which of the eight options that have been proposed by Tucson Water will be considered by Mayor and Council. Even if the City argues that it has provided the public with notice of a rate increase of up to 50%, that proposal isn’t in the notice and it isn’t clear how that range of up to 50% would apply to Tucson Water customers. Whether the City has provided the public with sufficient statutory notice of the proposed water rate increase will depend on whether a

court interprets A.R.S. § 9-511.01(A)(2) to require only notice of a rate increase generally or requires the City to provide notice of the rate increase that it will consider at the June 8th hearing.

3. *The City may not have complied with the requirement of A.R.S. § 9-511.01(A)(1) to provide a report or to supply data supporting a rate increase.*

A.R.S. § 9-511.01(A)(1) requires a municipality that proposes to increase a water rate to “[p]repare a written report or supply data supporting the increased rate” and make the report available to the public at least 30 days prior to the hearing on the proposed increase. “The report or supporting data shall include cash flow projections that indicate all anticipated revenues from residential and nonresidential customers and the overall expenses for providing water or wastewater service.” On May 7, 2021, the City posted notice on its website of “[d]ata supporting the proposed differential rate structure.” The data consisted of two documents including Tucson Water’s “Proposed Differential Rates for Unincorporated Pima County Customers” which is a table comparing the service and usage charges under current rates to expected charges under the proposed eight differential water rate options. The City’s data also included a Power Point slide-show presentation titled “Fiscal Year 21-22 Water Rates” that Tucson Water used in its presentations to the public.

The City may not have complied with the statute because it did not propose a rate increase 60 days before the hearing and, therefore, cannot provide a report or data supporting the increase. However, even if the City isn’t required to propose an actual rate increase, the data provided by the City still may not comply with the statute. The data doesn’t show support for applying any one of the eight options to every customer in unincorporated Pima County. The City may claim that the data presented in the slide-show presentation is sufficient because it includes data showing “Differential Infrastructure Use,” “Differential Resource Use,” and “Differential Conservation Results” between city residents and unincorporated nonresidents. But this data is not specific to any rate increase and argues for only a general policy of adopting a differential water rate structure. The City’s data also doesn’t appear to sufficiently provide cash flow projections and anticipated revenues from residential and nonresidential customers. As a result, there is an argument that the City is preparing to increase water rates on June 8th for all unincorporated customers without providing the public with the necessary report or data that supports the increase.

4. *The City’s Proposal to Increase Water Rates May Not Be Just and Reasonable.*

The legislature has not defined the “just and reasonable” standard that it established for a municipality’s proposed water rate increases and for rates demanded or received by municipalities. When the Arizona Supreme Court determined that a reasonableness standard must be read into A.R.S. § 9-516(C), the Court was considering a challenge to a Phoenix ordinance that doubled the water rates for customers living outside the jurisdiction of the city. The Court accepted the general rule that a municipality may charge more for water service outside its jurisdictional limits than it charges to the residents inside the limits. However, the municipality must have a reasonable basis for the discrimination. The Court recognized that if a municipality proves that service to nonresidents is more expensive, that proof would be sufficient to show a municipality acted reasonably when it increased the water rates for the nonresidents. The Court did not elaborate whether a city, such as Tucson, acts reasonably when it increases the water rates for all nonresidents based on the higher costs of serving a subset of those nonresidents. The merits of the Phoenix ordinance were not addressed because the Court found that the plaintiff brought the case under the wrong cause of action and remanded the case back to superior court.

The “just and reasonable” standard also applies to the Arizona Corporation Commission’s authority to prescribe rates and charges made by public service corporations. *See* Ariz. Const. art. XV, § 3, 12. The standard derives from the general theory of utility regulation that total revenue, including income from rates and charges, should be sufficient to meet a utility’s operating costs and give the utility and its stockholders a reasonable rate of return on the utility’s investment. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534 (App. 1978). To do this, the Commission is required to find the fair value of the utility’s property and use such finding as a rate base for the purpose of determining what are just and reasonable rates. *Residential Util. Consumer Off. v. Arizona Corp. Comm'n*, 240 Ariz. 108, 112 ¶ 14 (2016).

Because no Arizona court has interpreted the “just and reasonable standard” for municipalities in A.R.S. § 9-511.01, it is uncertain whether a court would apply the standard to municipalities in the same way. The Commission has plenary power over rate-making and courts have consistently held that the Commission must set “just and reasonable rates” that are fair to both consumers and public service corporations. *Phelps Dodge Corp. v. Arizona Elec. Power Co-op., Inc.*, 207 Ariz. 95, 107 ¶ 30 (App. 2004). The Commission has a duty to consider the interests of all whose interests are involved and protect consumers from the overreaching of public service corporations. *Id.* at ¶¶ 30-31.

An important distinction is that the legislature regulates the rate-making authority of a municipality. For example, A.R.S. § 9-511 sets standards for water rates that a municipality may charge to residents in another municipality. Those rates are not tested by a reasonableness standard and they do not apply to rates that a municipality charges to nonresidents in an unincorporated area of a County. *Jung at 41*. Therefore, how courts apply the standard of “just and reasonable” to the Commission may be helpful, but not determinative, for a court applying the standard to a municipal utility.

A court would also likely consider the plain meaning of the words just and reasonable to avoid the impossible situation addressed by the Arizona Supreme Court in *Jung v. City of Phoenix*. Black’s Law Dictionary defines ‘just’ to mean equitable and defines ‘reasonable’ to mean fair, proper, or moderate under the circumstances. A challenge arguing that the City’s proposal is unjust and unreasonable could be supported by the facts and arguments in the report attached to the County Administrator’s Memorandum to Supervisor Scott on March 16, 2021 as well as in the County Administrator’s Memorandum to the Board of Supervisors, dated May 10, 2021. Those memoranda address the inequities of the proposal and explain how the City’s proposal is unfair and improper to residents of unincorporated Pima County. There may also be an argument that a rate increase imposed on unincorporated customers for the purpose of raising revenue for the City is not just or reasonable.

5. *The City’s Proposal to Increase Water Rates for Residents of Unincorporated Pima County Potentially May Violate the Equal Protection Clause of the Arizona Constitution.*

The City’s proposal to implement a differential water rate structure based solely on whether a customer is in unincorporated Pima County may violate the customer’s equal protection rights under the Arizona Constitution. The right of equal protection is a guarantee that persons in like circumstances and like conditions be treated equally. *Waltz Healing Center, Inc v. Arizona Department of Health Services*, 245 Ariz. 610, 616 ¶ 24 (App. 2018). To establish an equal protection violation, a customer would have to show that the City’s proposal treats differently residents and nonresidents who are similarly situated.

This argument is plausible because the City's ordinance would discriminate among customers who are similarly situated but are on different sides of the jurisdictional boundary.

If a customer can show the discrimination, a customer would have to pass the rational basis test by showing that the proposal is not rationally and reasonably related to furthering some legitimate governmental interest. The rational basis test presents a high burden for a customer because absolute equality isn't constitutionally required for economic legislation such as an ordinance that imposes a differential water rate. However, the City's proposal may be susceptible to the challenge because it appears to be arbitrary and irrational. The City has offered various reasons for the rate increase – such as to encourage annexation, to cover water lost to septic systems, or to incentivize more efficient uses of water. But the determination of which customers will be subject to the higher rates is not based on any of these reasons. Instead, the ordinance will arbitrarily impose a higher rate based solely on whether the customer is outside the jurisdictional limits of the City. The City has not offered any rationale why the jurisdictional boundary is determinative of whether a customer should pay a higher rate for water. Until it does, there is a good argument that the ordinance violates the equal protection clause of the Arizona Constitution.

6. Conclusion

The City's proposal to adopt an ordinance that would apply differential water rates to the same class of customers based solely on whether a customer is within the jurisdictional boundaries of the City may not comply with the notice and reporting requirements of A.R.S. § 9-511.01. If the City proceeds with adopting the ordinance, a customer may have a claim that the water rate increase for unincorporated customers is neither just nor reasonable. A customer may also bring the additional challenge that the ordinance violates Arizona's equal protection clause for discriminating customers and arbitrarily and irrationally increasing rates based solely on the jurisdictional boundary.